
Annual Food Ingredient Executive Survey

Recipes for Growth – 2006

A “State of the Industry” Survey



Survey Conducted by Best Vantage Inc.
For J.H. Chapman Group, L.L.C.

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Introduction

A new state of the industry report examining the current status of the U.S. food and nutritional products sector reveals a healthy optimism among food ingredients suppliers, large and small. In fact, over two-thirds say the current business climate is good or excellent. Aggressive growth is expected during the next two years, as 44 percent of industry executives anticipate a sales increase of more than eight percent. So, how can your company ensure its share of the projected growth in the coming years?

J.H. Chapman Group, L.L.C. commissioned this independent study of senior-level executives from a broad cross-section of food ingredient categories to help the industry better understand key growth opportunities and the challenges it faces, and to consider how best to respond. The surveyed companies ranged in annual revenues from \$10 million to more than \$300 million. Here is what food ingredient executives had to say.

Drivers of Growth

While the food industry culture was once focused on being first to market, there seems to be a new shift in mindset toward innovation, customer service and available capital. According to the survey, these three areas represent leading drivers of growth in today's ever-changing food manufacturing environment.

When food ingredient executives were invited to rate growth engines, enhancing gross margins was singled out by more than 90 percent. This data might suggest a need for more cost-effective ways to market and sell ingredients, such as protecting price positions and streamlining work practices. Easy access to capital allows a company to invest in new equipment, technologies and manufacturing capability, giving them a competitive edge.

Yet, the winners of the battle for the food industry's share of mind and wallet might be ingredients suppliers focusing on product development. In fact, innovating new ingredients and applications is identified as a top strategy for growth by nearly 60 percent of respondents.

Food manufacturers are placing greater importance on industry partners capable of providing technical services and supplying relevant ingredients with solutions that help innovating existing products and diversifying into new product areas.

"While the industry is seeing a continuing need for convenience and quick meal solutions, there is a growing demand for healthier food products, such as functional foods, forcing food manufacturers into a continuous process of innovation," says Marco Galante, J.H. Chapman Group principal. "More sophisticated research and development may need to come from outside resources, requiring a strategic, 'specialized' partner."

Another key growth engine is quality customer service. The consensus among food ingredient executives (58 percent) is that technical support and overall responsiveness are imperative to increasing sales. Food ingredients executives understand the rewards of helping customers apply ingredients to new products in value-added ways, and consider this to differentiate their companies from competitors.

An expanded sales force is seen as a minimal growth driver by half of all respondents. Given the rate of salary and benefit packages, this is not surprising.

It is important to note that opinions about key growth engines vary by company size. Large food ingredient suppliers seem to place more emphasis on research and development than their smaller counterparts, which may reflect their availability of resources and funds.

Challenges Ahead

As the outlook appears bright, challenges exist both internally and externally, especially among large companies. Capital and cash flow needs are perceived as obstacles to growth, as indicated by nearly half of all respondents. This is good news if it indicates a need for additional production capacity, but not if it shows concern over increased cost of capital.

Nearly 90 percent of food ingredient suppliers say that raw material sourcing is another important growth obstacle. Rising costs of raw materials are putting the squeeze on food companies, forcing them to become more inventive in their operational and processing practices.

"Lack of focus" is one of the greatest single threats facing 50 percent of all food ingredients suppliers. As companies build their portfolios of product offerings, many may be losing sight of who they are and what they do best. For large companies, a portfolio

may become too broad, creating 'clutter', diluting competency and spurring overhead costs that impact gross margins. For smaller companies, a portfolio may be too narrow, limiting marketplace opportunities and 'broader' relevance.

"It is important that companies continually revisit their business plans, resources and budgets to stay nimble and competitive within the marketplace," says Galante. "Seek out ways to improve operational effectiveness, to account for market, customer, industry technology changes, and corporate responsibilities, as well as consider possible joint ventures, licensing, mergers and acquisitions."

Consolidation

Healthy growth often occurs through the development and execution of strategic business plans as well as internal capabilities, but such development can be slowed by internal constraints and limited access to capital. Growth can be accelerated through third-party coordination. While larger companies are more likely to lead the consolidation in the food industry, all companies should consider the benefits of a 'strategic partnership.'

Approximately 76% of food ingredients executives say acquisitions, strategic alliances or joint ventures are important to a growing business. The size of a company and its available resources will dictate the decision between acquisitions or joint ventures. Small-to-mid size companies are more likely to choose a joint venture, while larger businesses possessing greater financial capability are more likely to seek out an acquisition.

Primary benefits arising from acquisition may be the addition of a niche specialty, diversifying into a new product area, building critical mass, globalizing and entering a high growth product sector. Obstacles to strategic partnerships may include differences in corporate cultures, lack of commitment and lack of a shared vision.

"When considering a merger or acquisition, first clearly understand what it is that your business brings to the other and vice versa as well what you need most from your partner," advises Galante. "Moreover, never underestimate the importance of personal chemistry."

Marco V. Galante
(mgalante@jhchapman.com)

Executive Summary

The State of the Industry and Recipes for Growth

Objective: To gauge the status of the US food and nutritional products industry, with emphasis on the opportunities for new business growth and development among food ingredient suppliers.

➤ Response Rate

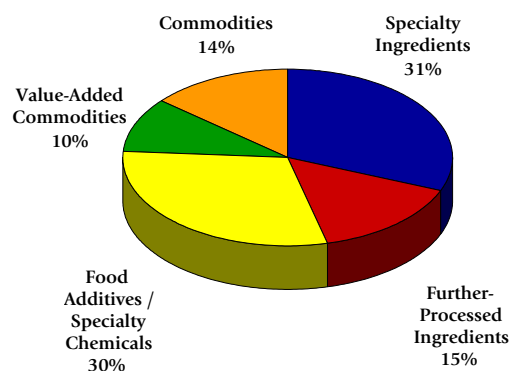
- A weighted average response of 25% was achieved, for a total of 50 respondents. Data was compiled and cross-referenced by company revenue level and by designated ingredient category.

➤ Respondent Categories

- Annual revenue

1. Start-up	Less than \$11 million
2. Small	\$11 million to \$50.9 million
3. Lower Middle Market	\$51 million to \$100.9 million
4. Upper Middle Market	\$101 million to \$300 million
5. Large	Above \$300 million
- Principal ingredient products
 1. Specialty Ingredients
 2. Further-Processed Ingredients
 3. Food Additives and Specialty Chemicals
 4. Value-Added Commodities
 5. Commodities

Distribution of Respondents by Ingredient Category



➤ Respondent Profiles

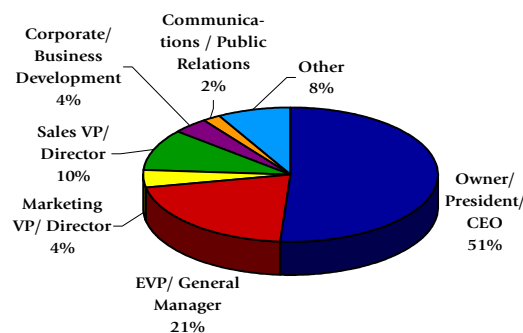
72% of respondents were either (51%) Owners/ Presidents/CEOs, or (21%) Executive VP/General Managers of their companies.

Sales, Marketing and Corporate Business Development executives represented an additional 17.5% of respondents.

Ingredient category designations reflect the degree of value addition represented by each category.

Most responses were generated by Category 1 (Specialty Ingredients) and Category 3 (Food Additives and Specialty Chemicals), although each ingredient category generated significant responses.

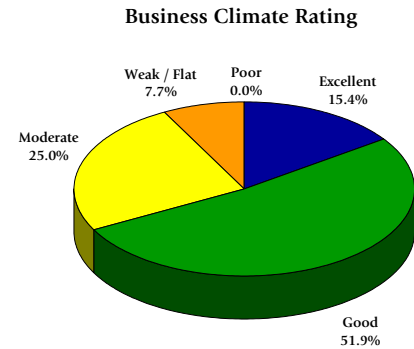
Distribution of Respondents by Title



State of the Food Industry

➤ Business Climate

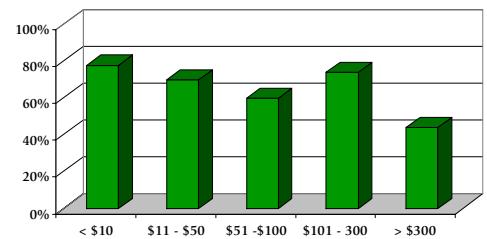
The business climate is rated good or excellent by 67% of respondents. Only 8% considered it to be weak or flat.



➤ Optimism

Optimism is strong across all company sizes, although it diminished somewhat with increased company size.

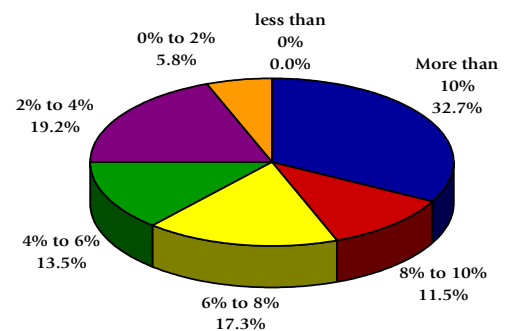
Business Climate Evaluations
Excellent to Good Ratings by Company Revenue in \$ millions



➤ Projected Growth

Most respondents expect aggressive growth during the next two years, with 44% anticipating sales to grow more than 8% annually.

Expected Annual Growth Rate – Next Two Years
Revenue in \$ millions



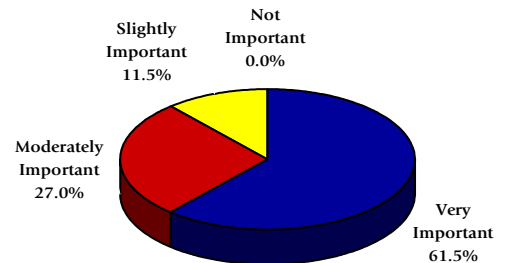
Engines and Alternate Strategies for Growth

Objective: To identify growth engines utilized by food ingredient companies within the current economic environment. The results suggest a renewed interest in technology development and innovation.

➤ Gross Margin

Enhancement of gross margin is the most important objective according to 88% of food ingredient company respondents. This suggests more emphasis on protecting price positions, market differentiation, and enhancement of intellectual property capital.

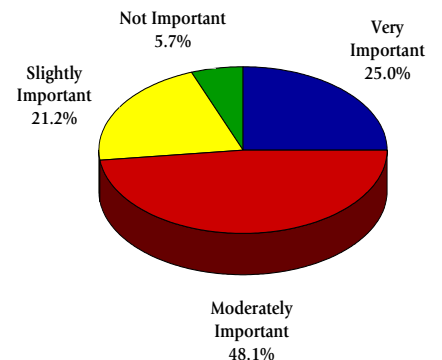
Gross Margin Enhancement as a Growth Engine for Your Company



➤ Marketing & Communications

Marketing and communications is about defining and projecting a compelling image of a company and its ingredients to its customers and food manufacturers. Nearly 75% of responding food ingredient companies consider marketing and communications to be very important or moderately important as a growth engine.

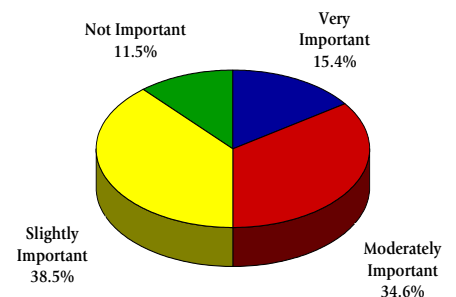
Marketing and Communications as a Growth Engine for Your Company



➤ Sales Force

Expansion of the sales force is rated “slightly important” or “not important” by half the respondents, and only 15% rated it as very important.

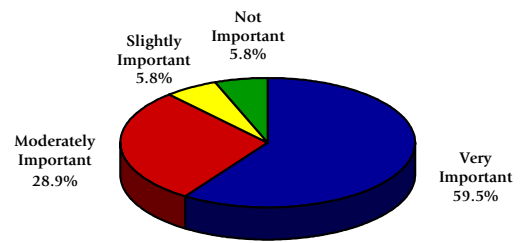
Sales Force Expansion as a Growth Engine for Your Company



➤ **R&D: New Ingredients & Applications**

Developing new ingredients and applications is considered a very important strategic objective by 59% of respondents.

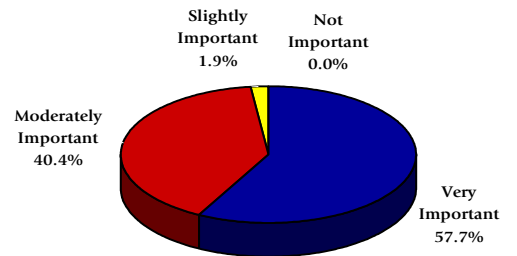
R&D: New Ingredients and Applications as a Growth Engine for Your Company



➤ **Technical Service/Customer Interface**

Service is rated very important by 58% of respondents.

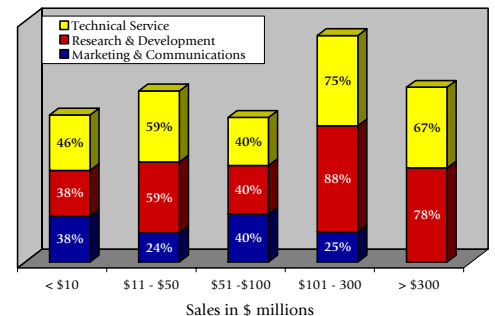
Technical Service/Technical Customer Interface as a Growth Engine for Your Company



➤ **Respondent Perspectives on Growth**

The relative importance of growth engines varies with company size. Small to mid-sized companies emphasize a greater mix of marketing, R&D and technical service capabilities, whereas large companies tend to place more focus on R&D and technical service capabilities than on marketing. This difference may indicate that larger food ingredient companies already enjoy established relationships with their customer base and feel less need to use marketing to communicate their corporate image or promotional messages to their customer base.

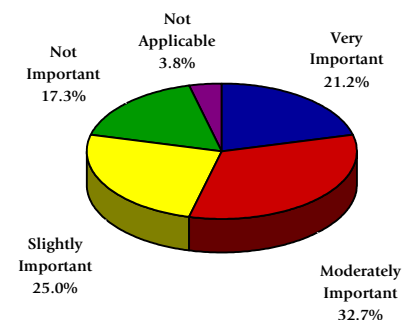
Food Ingredient Suppliers – Ratings of Growth Engines as a Function of Annual Sales



➤ **Cross-Border Sales**

Do food ingredient companies think globally but act locally? Only 21% of respondents indicated that cross-border sales growth was very important.

Cross-Border Sales Growth as a Growth Engine for Your Company



Growth by Acquisition, Joint Ventures and Strategic Alliances

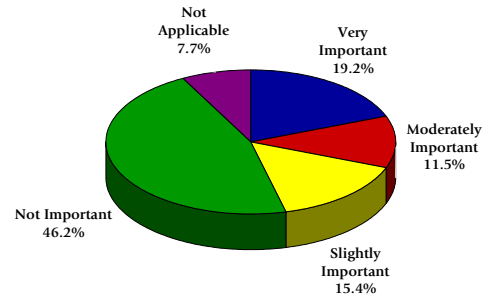
Over 30% indicated that growth by acquisition was very or moderately important.

Fifty-six percent of respondents indicate partnering and joint ventures are a moderately to very important strategic tool for growth.

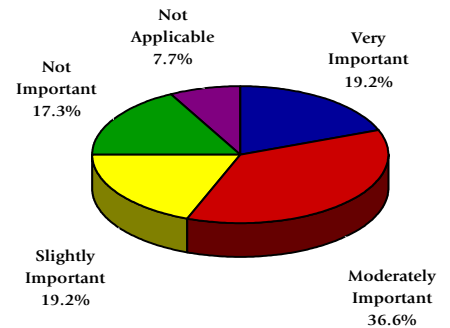
The relative importance of acquisitions, joint ventures and strategic alliances and growth engines varied with company size.

A closer look at responses reveals that company size is a major determinant of the importance of mergers and acquisitions to company growth relative to partnerships and joint ventures. Food ingredient companies seriously consider mergers and acquisitions as an engine for growth when they attain middle market status.

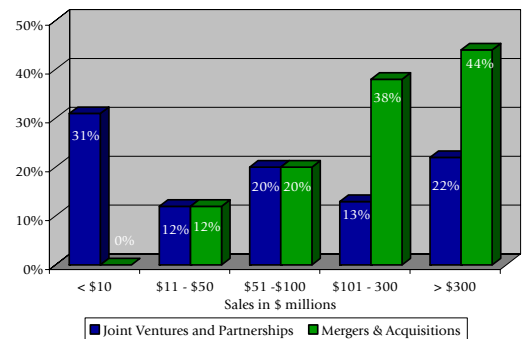
Acquisitions as a Growth Engine for Your Company



Partnerships and Joint Ventures as Growth Engines for Your Company



Growth Engines Joint Ventures and Partnerships vs. Mergers & Acquisitions by Company Size Category



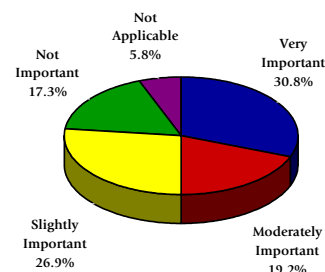
Challenges to Growth

Challenges to growth are encountered, or perceived, with each and every strategy. These include economic, financial, market driven competition, market consolidation and other factors.

➤ Capital Needs

About half of the respondents indicate that capital and cash flow needs present important challenges to growth.

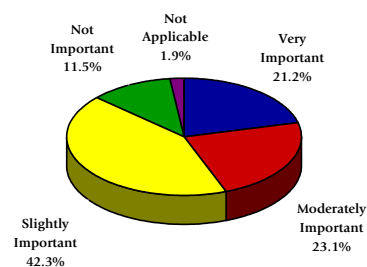
Capital and Cash Flow Needs as an Obstacle to Growth for Your Company



➤ International Competition

Competition from international ingredient suppliers is perceived to be a moderately to very important obstacle to growth by 44% of respondents, although only four cited Asian competition as an obstacle to growth.

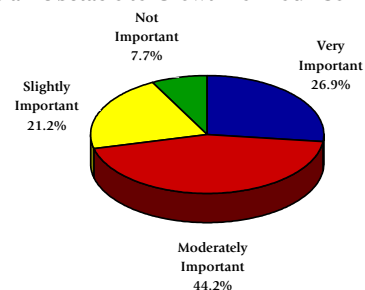
International Competitors as an Obstacle to Growth for Your Company



➤ Sales & Marketing

Fully 71% of respondents indicated that sales and marketing capabilities presented a significant obstacle to growth for their companies.

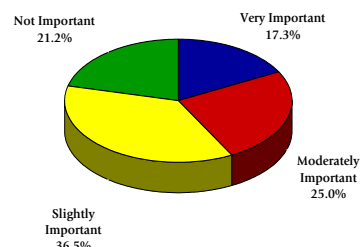
Sales and Marketing Capabilities as an Obstacle to Growth for Your Company



➤ Global Uncertainty

Global uncertainty is not generally perceived as a major obstacle to growth by food ingredient companies.

Global Uncertainty as an Obstacle to Growth for Your Company



➤ Raw Material Sourcing

62% of respondents perceive this to represent a moderately to very important obstacle to growth.

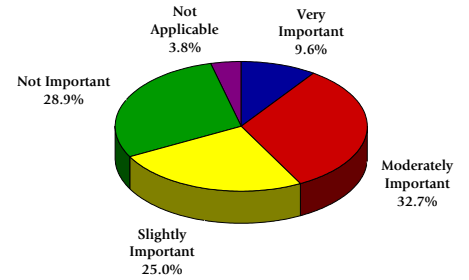
➤ Energy/Utility Costs

64% of respondents deem this challenge as moderately to very important.

➤ **Lack of Core Market Focus**

42% of respondents acknowledge that their own companies ought to develop a better-defined market focus.

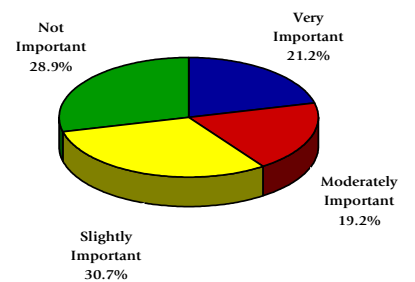
Lack of Core Market Focus as an Obstacle to Growth for Your Company



➤ **Internal Structural Flexibility**

40% of respondents identify lack of flexibility as moderately to very important as a challenge for further growth.

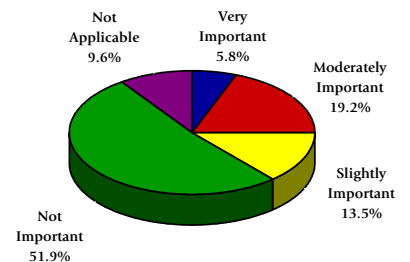
Lack of Internal Structural Flexibility as an Obstacle to Growth for Your Company



➤ **Lack of Suitable Acquisition Candidates**

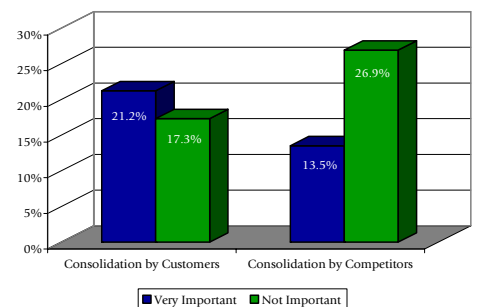
Approximately 25% of respondents are actively searching for acquisition opportunities, but availability of ingredient supplier candidates for acquisitions is not viewed to be a serious obstacle to growth.

Lack of Suitable Acquisition Candidates as an Obstacle to Growth for Your Company



➤ **Industry Consolidation by Competitors and by Customers**

30% rate consolidation by competitors as moderately to very important, and 21% rate by customers as a very important concern.



Methodology

One of the dominant trends in the U.S. food industry is a shift in the technological and food product development capabilities of food manufacturing companies toward the food ingredient companies that supply them with goods and services. Accordingly, this report reflects that the food supplier industry has become a leading indicator and incubator in the fortunes of the food manufacturing industry.

The second Annual Food Ingredient Executive Survey was commissioned by the J.H. Chapman Group, L.L.C., to identify growth trends and drivers within the U.S. food ingredient industry. Only U.S.-based companies or the U.S.-affiliates of foreign-headquartered companies were contacted for this study.

The stated objectives of the study were to:

1. Establish benchmarks for food industry innovation at the food ingredient supplier level.
2. Gauge avenues and opportunities for new business growth and development among food ingredient suppliers.
3. Develop new support services for suppliers engaged in the food and nutritional ingredient-supplier industries.

The web-based survey designed and conducted by BEST VANTAGE Inc. had an excellent reply success rate of 25%, for a total of 50 respondents. Data was compiled and cross-referenced by ingredient category and company size.

Food Ingredient Supplier Categories

Food ingredient respondents were categorized by company size and the primary food ingredient categories manufactured. Respondent companies were size-differentiated as follows:

1. **Start-up Companies** less than \$10.9 million in annual sales
2. **Small Companies** between \$11.0 and \$50.9 million in annual sales
3. **Lower Middle Market** between \$51.0 and \$100.9 million in annual sales
4. **Upper Middle Market** between \$101.0 and \$300.0 million in annual sales
5. **Large Companies** more than \$300 million in annual sales

Respondent companies were categorized by primary products as reflected by the degree of value addition represented by each category. Consequently, for example, ingredient blends and premixes were put into a higher category than specialized food chemicals. This ranking system does not necessarily reflect pricing or gross margin profitability for specific ingredients.

For the purposes of the survey, ingredients were categorized as follows:

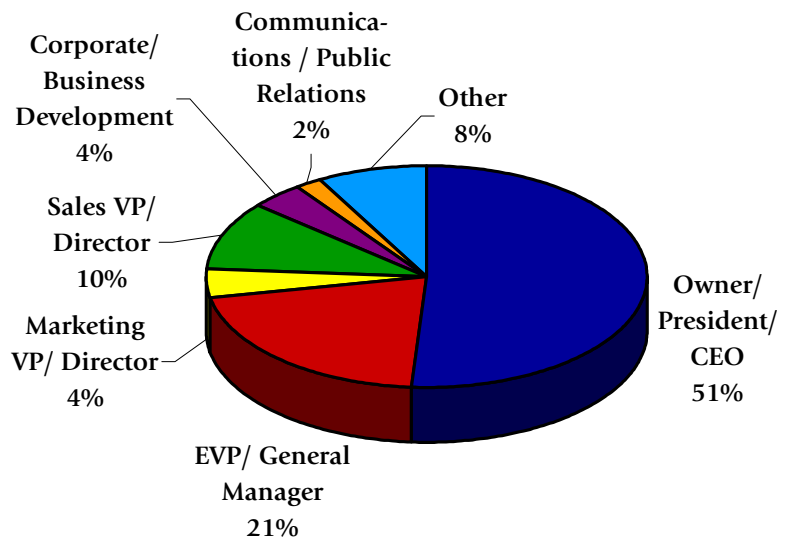
1. **Specialty Ingredients**
Colors; Flavors/Extracts; Herbs; Teas; High Intensity Sweeteners; Nutraceuticals; Peptides/Nucleotides; Specialty Oils; Spices and Seasonings; Sugar Polyols.
2. **Further-Processed Ingredients**
Beverage Mixes; Bakery Mixes and Premixes; Cereal Flakes; Bits and Breadings; Cookie Pieces; Fillings and Toppings; Fruit Preparations; Frostings; Whipped Toppings; Glazes; Ice Cream Mixes; Prepared Foods; Sauces; Soups and Dressings; Snack and Cereal Pellets; Syrups; Vinegars; Wines and Spirits.
3. **Food Additives and Specialty Chemicals**
Acidulants and Phosphates; Antioxidants; Baking Powders; Cultures and Yeasts; Dietary Fibers; Emulsifiers; Enzymes; Gelatins; Gums & Hydrocolloids; Polydextrose; Preservatives; Processing Aids; Protein Isolates and Concentrates; Stabilizers; Starches and Maltodextrins.
4. **Value-Added Commodities**
Brans and Germs; Cheese and Cultured Dairy; Fruits – fresh, frozen, dry; Juices and Blends; Meat, Fish and Poultry; Nutmeats and Seeds; Vegetables – fresh, frozen, dry.
5. **Commodities**
Bulk Sweeteners; Honey; Butter and Margarine; Cocoa Powders; Milk and Whey Powders; Fruit and Vegetable Powders; Oils and Shortenings; Coffee; Salt; Cereal and Legume Flours.

Respondent Profiles

Distribution of Respondents by Title

72% of respondents were either (51%) Owners, President/CEOs, or (21%) Executive VP/General Managers of their companies. Sales, Marketing and Corporate Business Development executives represented an additional 17.5% of respondents.

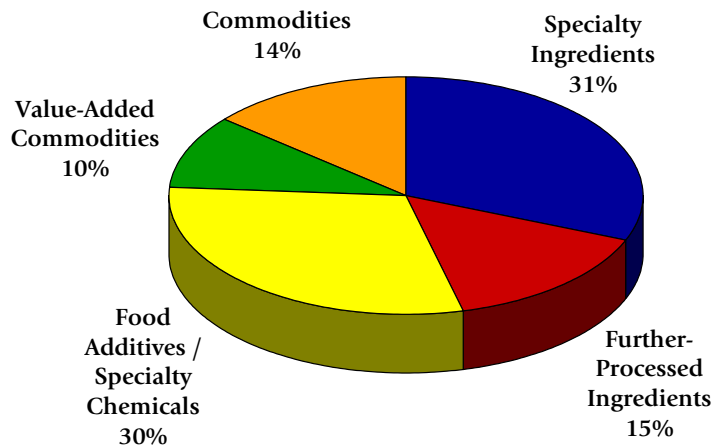
n = 50 companies



Distribution of Respondents by Ingredient Category

Most responses were generated by Category 1 (Specialty Ingredients) and Category 3 (Food Additives and Specialty Chemicals), although each ingredient category generated significant responses.

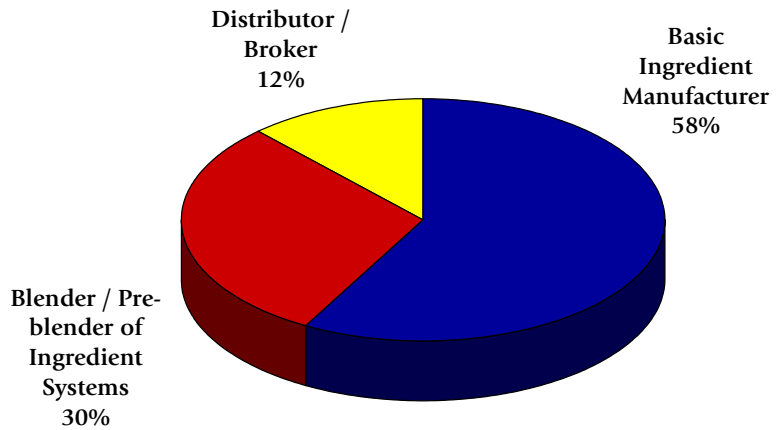
n = 50 companies



Distribution of Respondents by Ingredient Business Category

Responses were 58% from companies defined as primary ingredient suppliers, 30% from blenders and 12% from companies defined primarily as brokers and distributors of food ingredients manufactured by others.

n = 50 companies



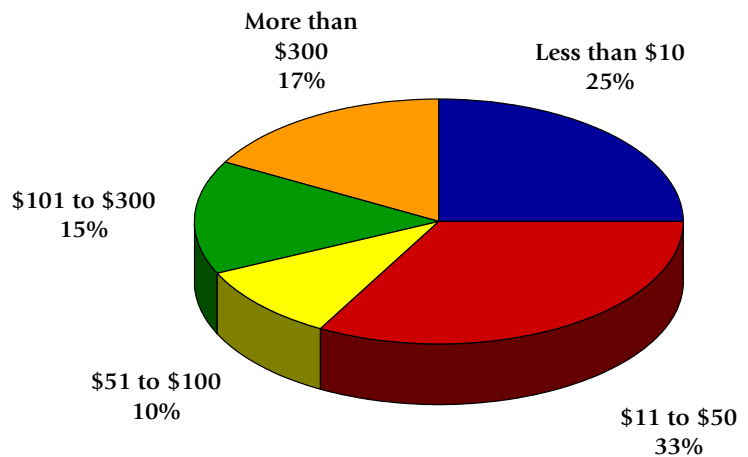
Distribution of Respondents by Company Size
Annual Sales in \$ millions

Small and lower-middle market companies, combined, generated 58% of responses.

The largest size category of ingredient suppliers (over \$300 million in annual sales) generated 17% of responses.

It appears that this distribution of respondents accurately reflects the size distribution of food ingredient companies in the U.S.

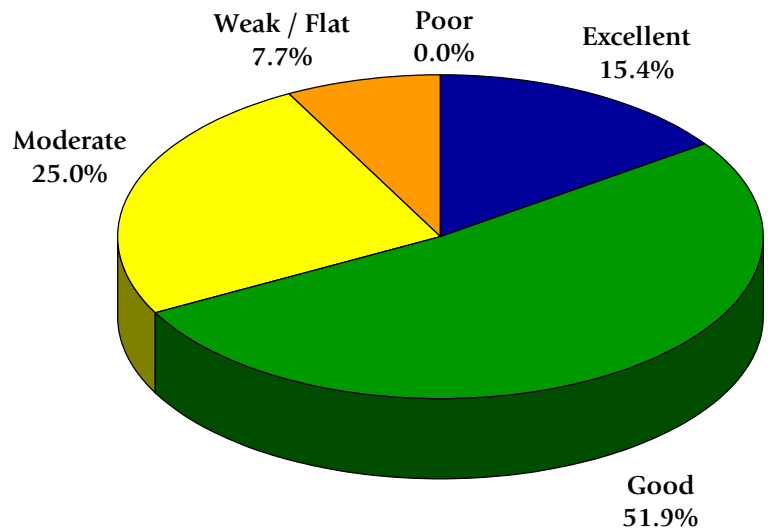
n = 50 companies



State of the Food Industry

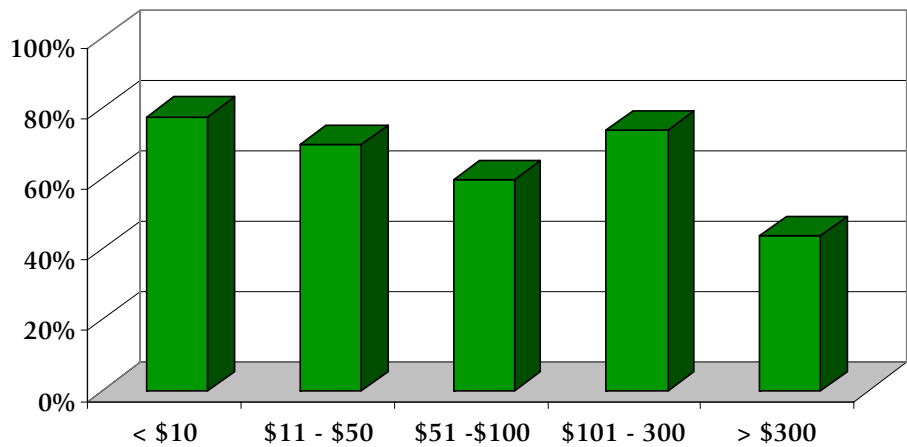
The food ingredient industry is highly optimistic about its prospects for growth over the next two years. Over 67% of respondents rate the business climate as good to excellent. Only 8% rated it weak to flat. Optimism is strong across all size categories, although it diminished somewhat with increased company size.

Business Climate Ratings



Business Climate Evaluations

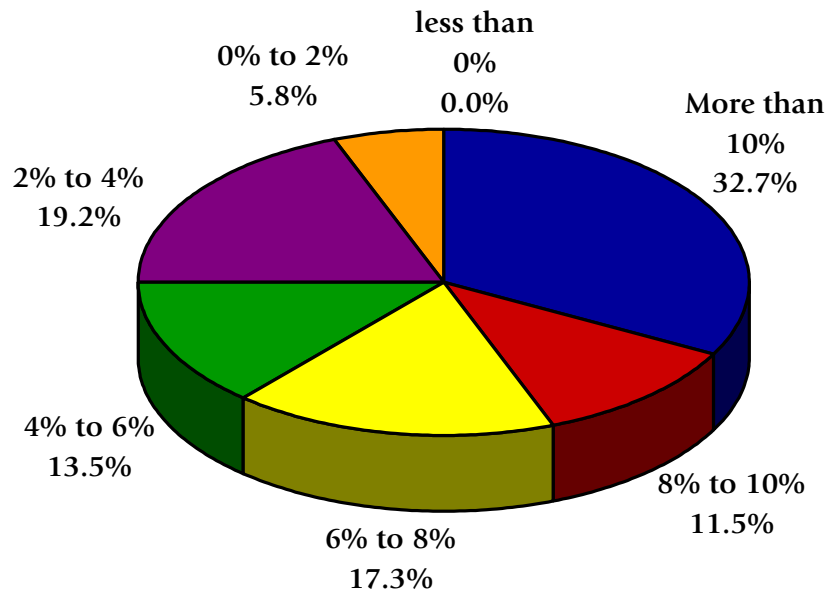
Excellent to Good Ratings by Company Revenue in \$ millions



Most respondents anticipate rapid industry growth over the next two years: 44% expect sales of the food ingredient industry to grow at an annual rate of more than 8%, and only 24% anticipate growth of 4% or less.

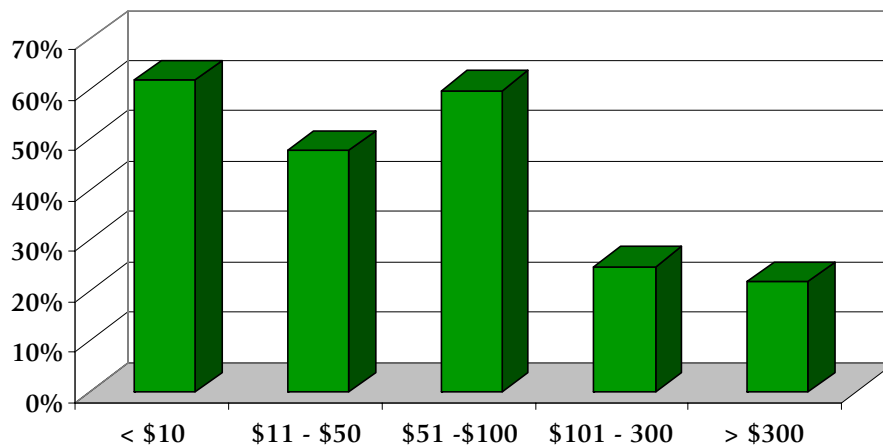
Projected growth rates are especially strong for ingredient companies with less than \$100 million in annual sales. Although uniformly strong across all categories, Category 4 projections (Value-Added Commodities) were particularly bullish, with 75% of respondents projecting annual growth rates of 8% or more over the next two years.

Expected Annual Growth Rate – Next Two Years



Growth Rate Projections by Company Size

Respondents Projecting Growth Greater than 8% by Company Revenue in \$ millions



Engines of Growth

Seldom is a food ingredient company all things to all customers, so companies differentiate by emphasizing different strategies: sales and service, new technology development, or marketing tactics.

Most companies make strategic decisions as to which growth engines are most important. Do companies make free and full use of all the competitive tools at their disposal, or are such decisions dictated by economic events and competitive necessity? Survey results suggest a major shift by the industry towards R&D and customer service.

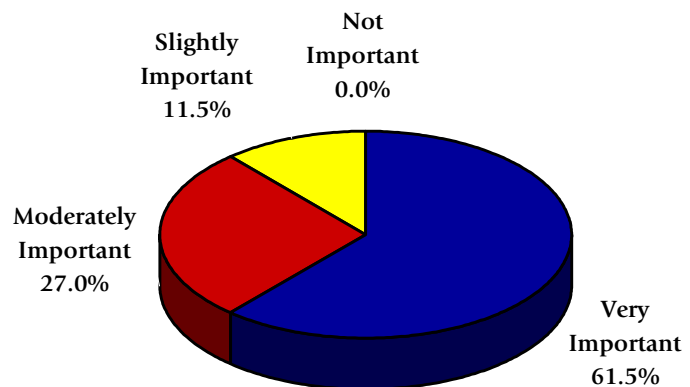
Easy access to capital may induce companies to invest in new equipment, technologies and manufacturing capacity. Tight labor markets may drive companies to find new, more cost-effective ways to market and sell their ingredients. Rapidly evolving communications technologies change the ways that food ingredient companies interact with their customers. Lack of competitive differentiation has posed long-standing challenges to food ingredient companies, leading to price cutting and the commoditization of food ingredients.

Food manufacturing companies follow trends. Easy access to capital and strong balance sheets encourage acquisitions activity. Expensive ingredient and production costs lead to tightened gross margins and reduced investments in new products and manufacturing capacity.

The objective of this section is to identify the relative importance of growth engines utilized by food ingredient companies in the current economic environment. Such information provides insights into the current competitive environment for food ingredients as well as benchmarks for performance.

Gross Margin Enhancement as a Growth Engine

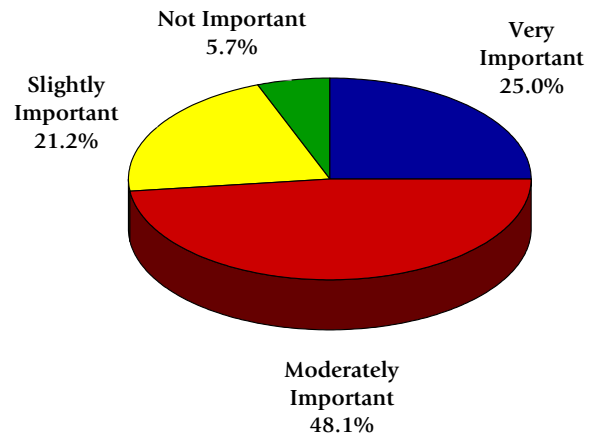
Margin enhancement remains a leading objective for 88% of food ingredient company respondents, suggesting an emerging emphasis on protecting price positions, market differentiation, and the enhancement of intellectual property capital. Not surprisingly, gross margin enhancement was judged to be very important by 70% of respondents in the highly price-competitive Category 5 (Commodity Ingredients), indicating a significant trend away from commoditization.



Marketing and Communications as a Growth Engine

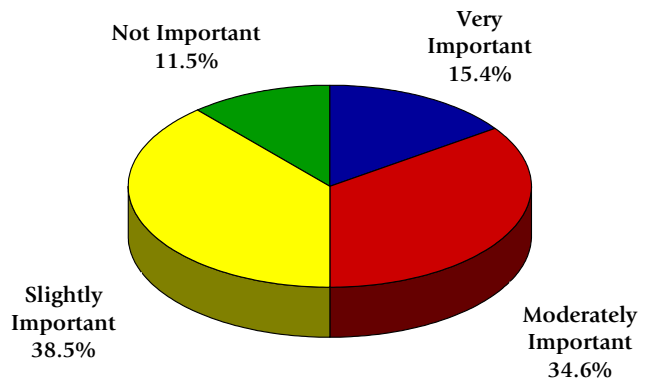
Marketing and communications is about defining and projecting a compelling image of a company and its ingredients to its customers and food manufacturers. Nearly 75% of responding food ingredient companies consider marketing and communications to be very important or moderately important as a growth engine.

Interestingly, marketing and communications was judged to be very important by a majority (57%) of respondents from Category 4 companies (Value-Added Commodities), suggesting a serious effort by this segment to market differentiate their products into higher margin categories.



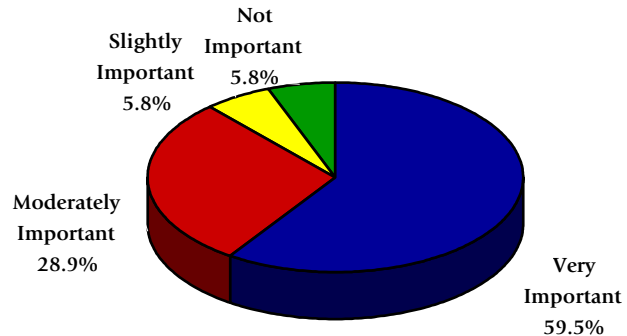
Sales Force Expansion as a Growth Engine

Is there a glut of sales representatives, or does the low ranking of sales force expansion as a growth engine reflect the changing nature of sales? Sales force expansion was rated as being very important by only 15% of respondents, while 50% of respondents rated it to be only "slightly important" to "not important." This may indicate a high degree of confidence in existing sales and marketing capabilities, or that there is an avenue of differentiation open for companies to put more emphasis on sales, marketing and promotion.



R&D: New Ingredients and Applications as a Growth Engine

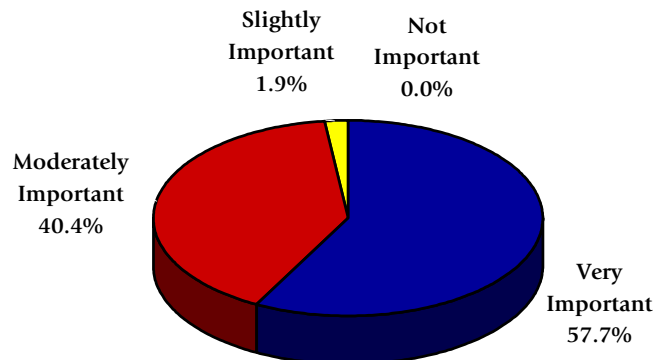
Another competitive strategy is to emphasize the R&D of new ingredients and technologies that can be price-differentiated to contribute to enhanced gross margin returns. This requires investment, which flourishes in times of low interest rates, reduced tax burdens, increased world trade activity, and related inducements to enhanced economic activity. Changing food regulations, such as the required labeling of trans-fats and food allergens, can also provide an important spur to food ingredient innovation.



Whereas 59% of all respondents identify “developing new ingredients and applications” as a very important strategic objective, the percentage increased to 86% and 70% for Categories 4 (Value-Added Commodities) and 5 (Commodities), suggesting an industry trend away from commoditization. The companies most oriented to technical services were those in Category 2 (Further-Processed Ingredients): 91% of Category 2 respondents rated technical services to be a very important growth engine.

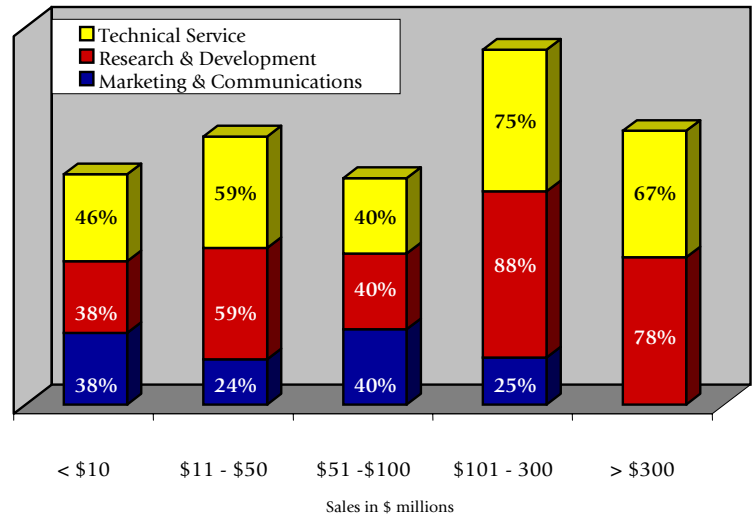
Technical Service/Technical Customer Interface as a Growth Engine

Technical service can provide support in product formulations, customization of ingredients and blends, and education of product developers in the use of food ingredients. New ingredient technologies create needs for technical support to help customers apply new ingredients in value-adding ways. Consequently, technical service and support complements new food ingredient and technology R&D programs.



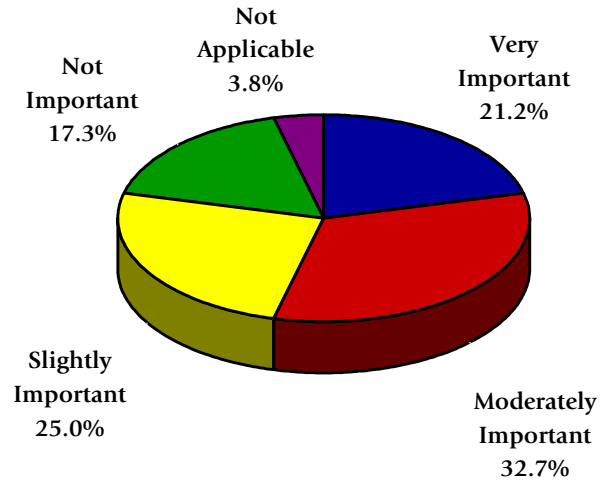
Food Ingredient Suppliers – Growth Engines as a Function of Annual Sales

Growth engines vary with company size. Small to mid-sized companies emphasize a fairly even mix of marketing, R&D and technical service capabilities. Large companies tend to deemphasize marketing in favor of R&D and technical service capabilities. This divergence may indicate that larger food ingredient companies already enjoy established relationships with their customer base and feel less obligated to use marketing to communicate their corporate image or promotional messages to their customer base.



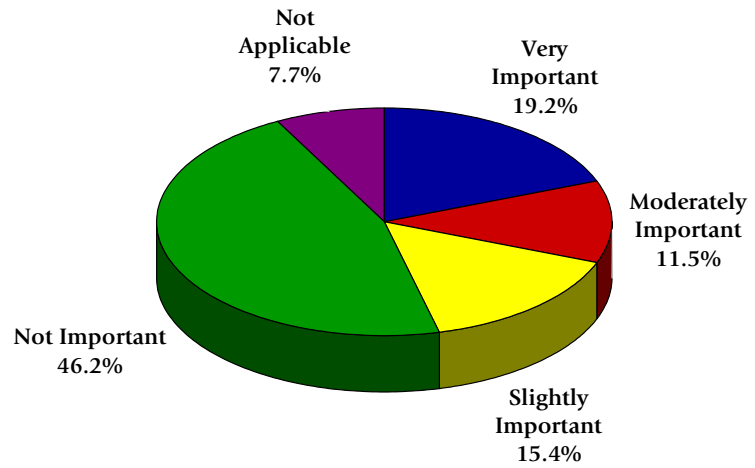
Cross-Border Sales Growth as a Growth Engine

Do food ingredient companies think globally but act locally? Only 21% of respondents indicated that cross-border sales growth was very important.



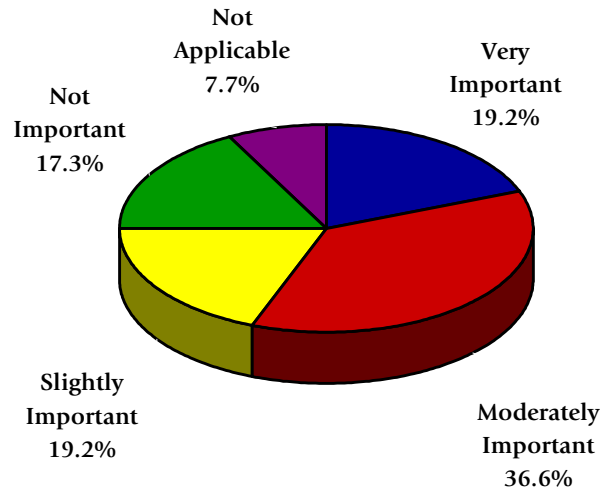
Acquisitions as a Growth Engine for Your Company

Multiple reasons exist for companies to acquire other companies, and 19% of respondents indicated that growth by acquisition was very important to them. However, the 54% of respondents who say that acquisitions are “not important” or “not applicable” may be missing a potentially valuable opportunity for growth. The exceptions were Category 2 companies (Further-Processed Ingredients) and Category 5 companies (Commodities), where 45% and 50% of respondents indicated that acquisitions represent an important growth engine for their companies.



Partnerships and Joint Ventures as Growth Engines for Your Company

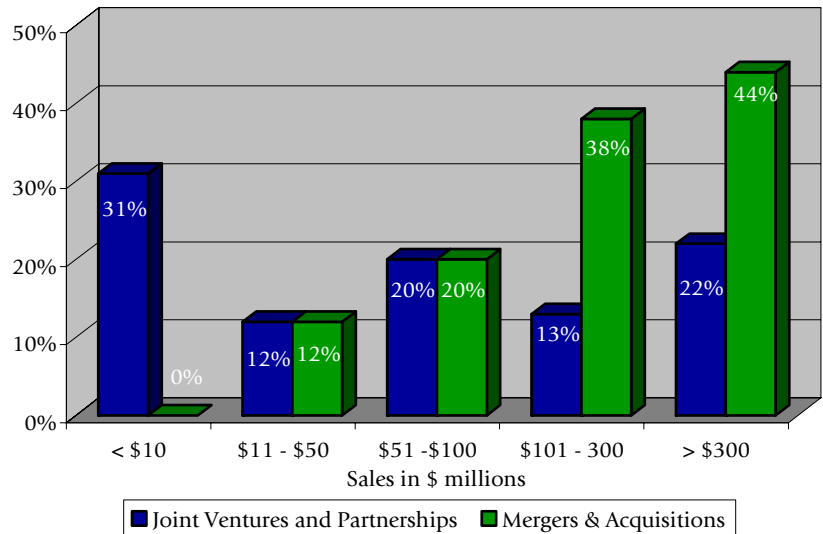
Growth through partnerships and joint ventures was viewed positively by all categories, especially by small companies that (presumably) may believe that they have less access to capital and may also be less aware of the financial tools at their disposal. 56% of respondents considered partnerships and joint ventures to be moderately to very important strategic tools for growth.



Growth Engines
Joint Ventures and Partnerships vs. Mergers & Acquisitions
by Company Size Category

A closer look at responses reveals that company size is a major determinant of the importance of mergers and acquisitions to company growth relative to partnerships and joint ventures. Food ingredient companies seriously consider mergers and acquisitions as an engine for growth when they attain middle market status.

This may be indicative of small companies' focus on developing well-defined niches through internal growth. Larger companies, by contrast, may look to new markets for incremental growth as they outgrow well-defined niches. It is also possible that smaller companies are less aware of the opportunities available to them for generating growth through acquisition.



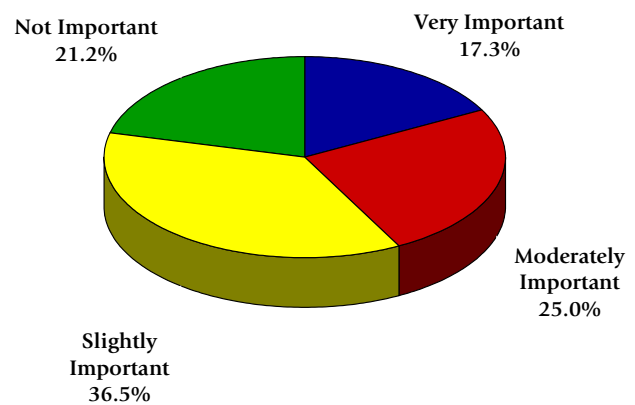
Other growth engines cited by respondents include improved access to capital, the impact of mega-customers such as McDonald's Corporation or Wal-Mart to drive growth, and the need or ability to control energy costs.

Obstacles to Growth

Every strategic plan faces obstacles. Obstacles can be economic, financial, competitive, market-driven or perhaps merely perceived. Uncertainty causes some companies to delay and wait until events reduce risk exposures. Other companies thrive during the creative transitions in the global economy.

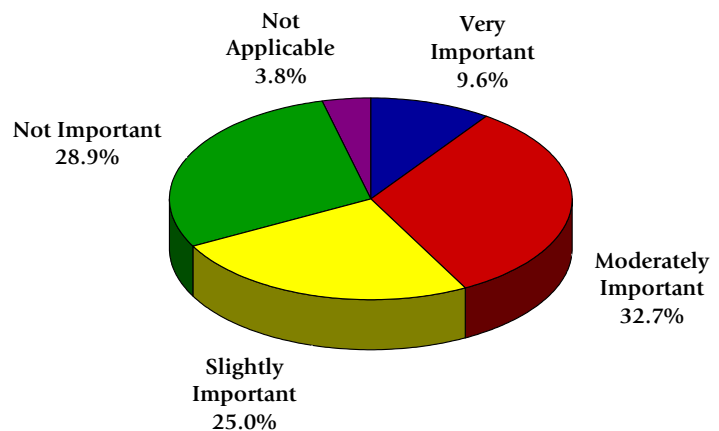
Global Uncertainty as an Obstacle to Growth for Your Company

Global uncertainty is not generally perceived as a major obstacle to growth by food ingredient companies.



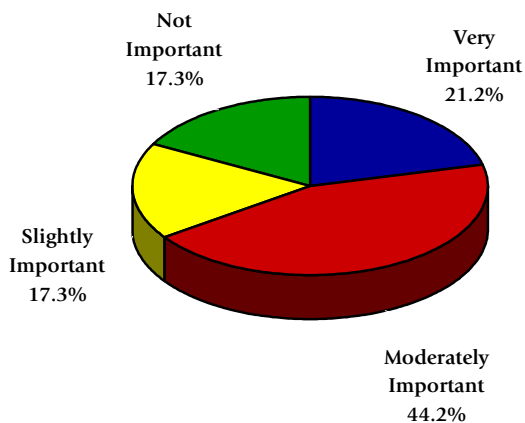
Lack of Core Market Focus as an Obstacle to Growth for Your Company

Few respondents believe that their own companies lack focus, although approximately 42% acknowledge that their own company's business focus could be better defined. Lack of company focus presents a marketing challenge...recall the 5-p's of marketing – "product, price, *position* (*i.e., focus*), promotion and perspective". As indicated in the previous section, sales and marketing activities do not head survey respondents' growth engine priorities.

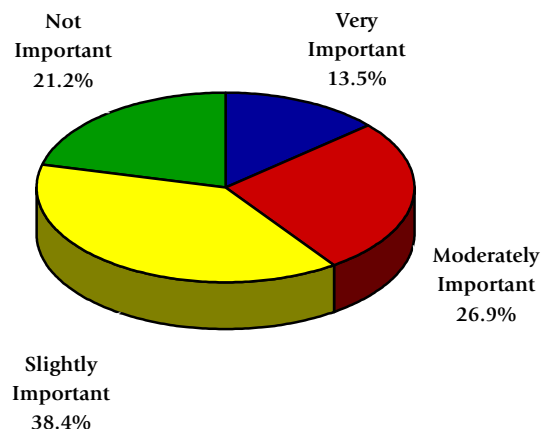


Industry Consolidation as an Obstacle to Growth for Your Company

By Customers



By Competitors

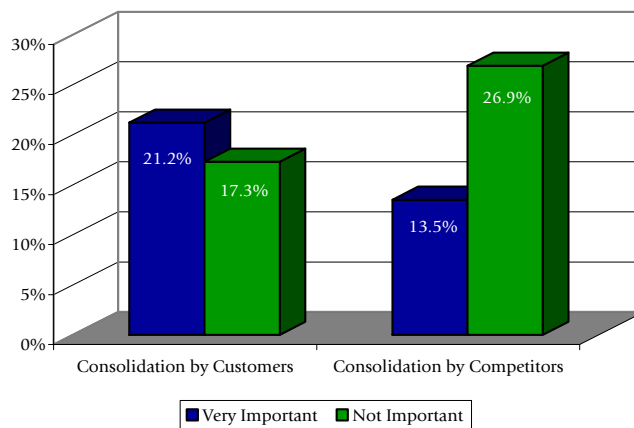


A “Wal-Mart” economy? Some in the industry express concern that continued industry consolidation will squeeze out individual companies (especially small companies) and consolidate industry purchasing power into fewer hands. Industry consolidation by customers represents a very important concern for only one in five respondents (21%). An alternate view posits that food industry consolidation opens new, niche market opportunities to be filled by up-and-coming small companies that eventually become big companies...or get acquired. Consolidation by competitors is not a serious obstacle to growth; only 14% of respondents rate it a very important concern.

To summarize, industry consolidation by neither customers nor competitors is viewed as a major concern by food ingredient suppliers, with two exceptions:

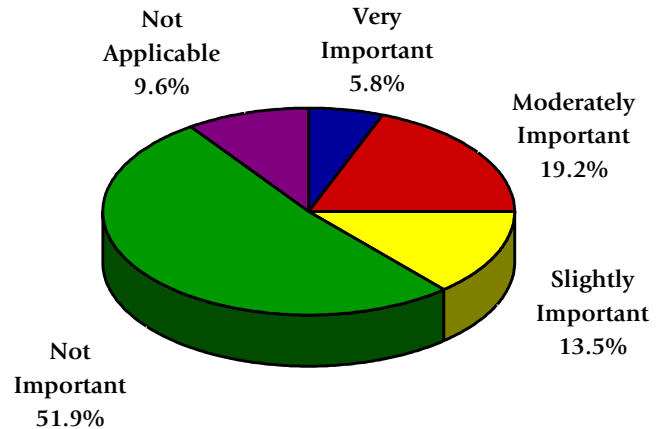
Among Category 2 companies (Further-Processed Ingredients), 82% of respondents indicated that consolidation by customers is a moderately to very important obstacle to growth.

Among Category 5 companies (Commodity Ingredients), 80% of respondents identified consolidation by customers as a moderately to very important obstacle to growth.



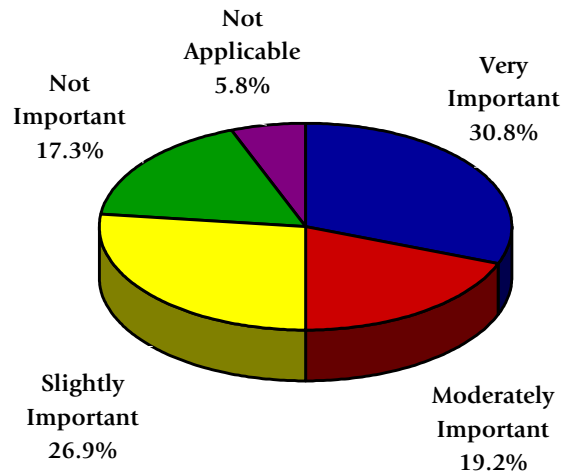
**Lack of Suitable Acquisition Candidates
as an Obstacle to Growth for Your Company**

What about acquisitions? Availability of ingredient supplier candidates for acquisitions is not viewed to be a serious obstacle to growth, even as approximately 25% of respondents suggest that they actively seek acquisition opportunities. The one exception is Category 5 (Commodity Ingredients), where 60% of respondents felt that a lack of suitable acquisitions presented a significant obstacle to growth.



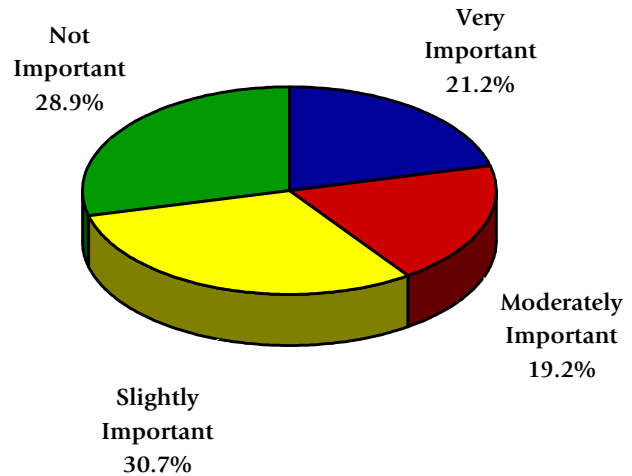
**Capital and Cash Flow Needs
as an Obstacle to Growth for Your Company**

Some obstacles to growth are external, while others are internal. Limited access to capital, lack of liquidity and heavy debt obligations are perceived to be obstacles to growth. Of course, the importance of access to capital varies. Cash requirements for capital investment or debt retirement are viewed more positively than cash or debt obligations incurred to fund continuing operations. In today's upward-trending economy, approximately 50% of food ingredient company respondents indicated that capital and cash flow needs present important obstacles to growth. This is good news if it reflects a need for additional production capacity but not if it reflects increased interest rate concerns.



**Lack of Internal Structural Flexibility
as an Obstacle to Growth for Your Company**

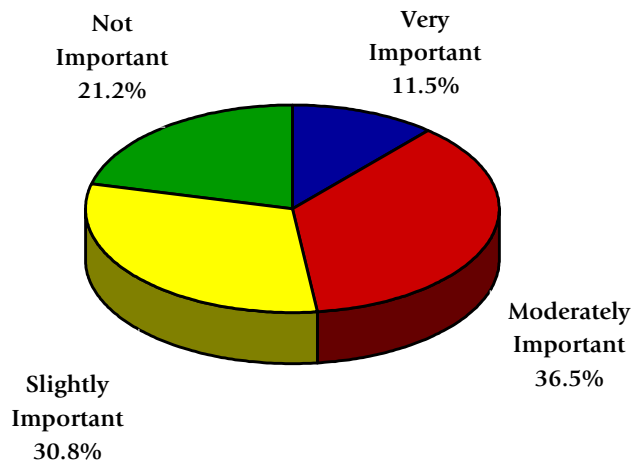
As companies grow, management capabilities must keep pace. Larger companies are more complicated to manage. As growth requires an ability to attract quality talent and to adapt to new, evolving internal communications needs, human resource assets become especially important. 40% of respondents identified internal structural flexibility concerns as mild to severe problems to be managed. Interestingly, this concern was evenly spread across all ingredient categories but was felt most acutely by middle market companies (\$51 million to \$300 million in annual sales), where 60% of executives expressed concern about lack of structural flexibility as an obstacle to growth.



**Preferred Supplier Listings
as an Obstacle to Growth for Your Company**

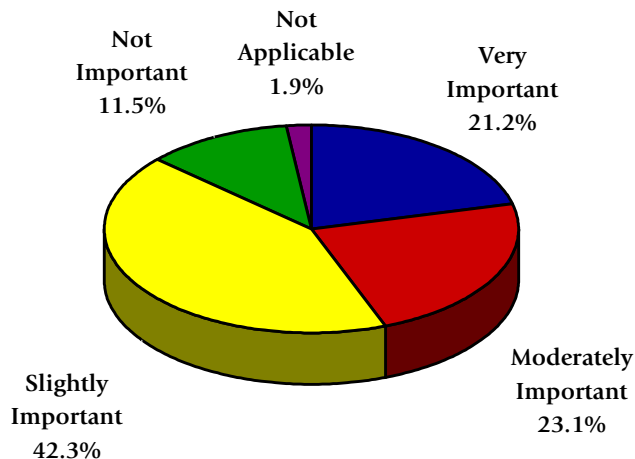
Within the United States, limitations by large food manufacturers on the number of ingredient suppliers on approved vendor listings have been identified as an obstacle to growth in past surveys. Sometimes this reflects stringent food quality and safety compliance requirements, as designated and audited by organizations such as AIB-International and the FPA-Safe programs.

A significant proportion of survey respondents (48%) perceive their customers' preferred supplier listings as obstacles to growth. Others may regard preferred supplier listings as opportunities.



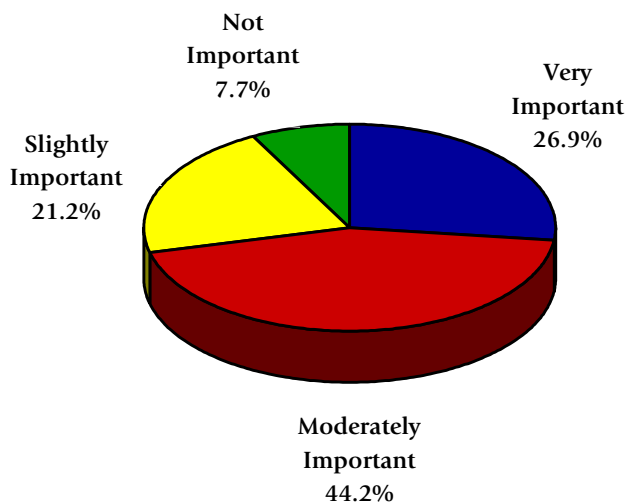
**International Competitors
as an Obstacle to Growth for Your Company**

Overall, competition from international ingredient suppliers was perceived to be a moderately to very important obstacle to growth by 44% of respondents. Asked to list their three biggest obstacles to profitability, only four respondents cited competition from Asian companies as obstacles. Category 4 companies (Value-Added Commodities) were the most likely (63%) to identify international competition as a moderately to very important obstacle to growth.



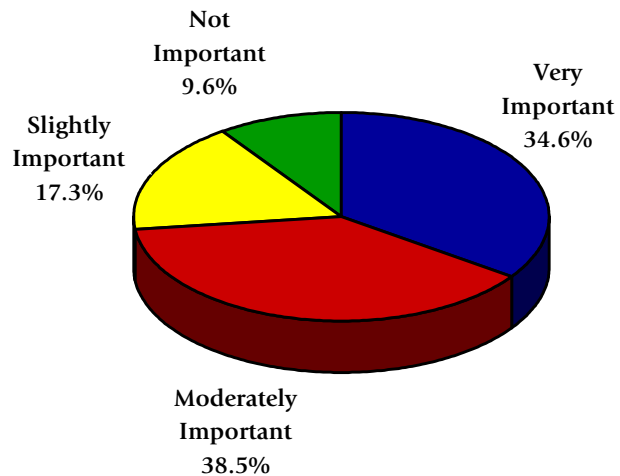
**Sales and Marketing Capabilities
as an Obstacle to Growth for Your Company**

Though not perceived to be as strong a growth engine as R&D or technical service, sales and marketing capabilities still present significant challenges to food ingredient executives. In seemingly contradictory responses to the results highlighted in the preceding chapter (Engines of Growth), fully 71% of respondents indicated that sales and marketing capabilities presented a significant obstacle to growth for their companies. The need for good sales and marketing capabilities was particularly acute for Category 4 companies (Value-Added Commodities), where 80% of respondents identified insufficient sales and marketing as a moderately to very important obstacle to growth. Competition from international suppliers may be most aggressive for these companies.



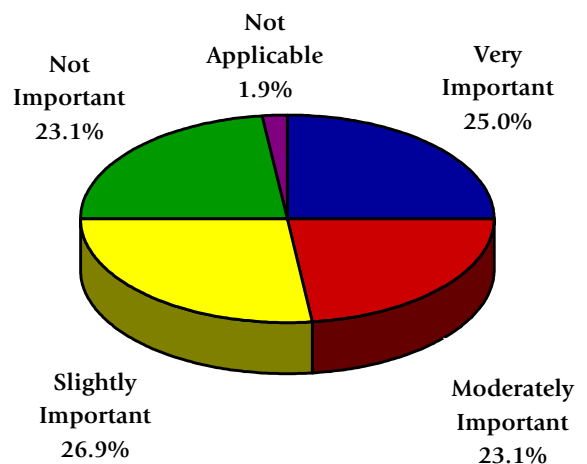
Market Demand as an Obstacle to Growth for Your Company

The role of marketing is to identify, create and defend market position. Market demand also figures high on the radar screen of food ingredient executive concerns – for 73%, anyway. Lack of market demand for a supplier's ingredients was identified as a significant obstacle to growth for 100% of Category 3 respondents (Food Additives and Specialty Chemicals), indicating a threat of stagnation.



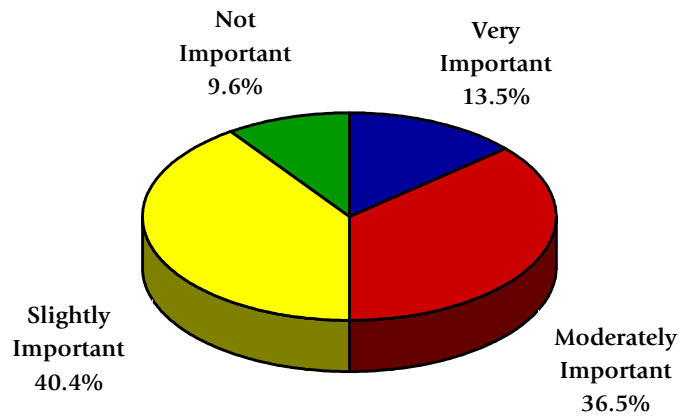
Government Regulation as an Obstacle to Growth for Your Company

Could government regulation be good for the food industry? Historically, once headaches of regulatory compliance have been addressed, government regulation has often proved to be a boon to new product development – think of the 1993 Nutritional Labeling and Education Act (NLEA) and its stimulus to product development. On the flip side, government regulations in the form of trade barriers stifle sales, and quality and safety compliance costs diminish profitability. Food ingredient executives appear to be evenly split on the impact of government regulation on their companies' growth prospects. Concerns about government regulation were least pronounced among smaller companies, possibly because new regulations create new niche market opportunities. One respondent did cite the "cost of doing business in California" as one of the biggest obstacles to profitability.



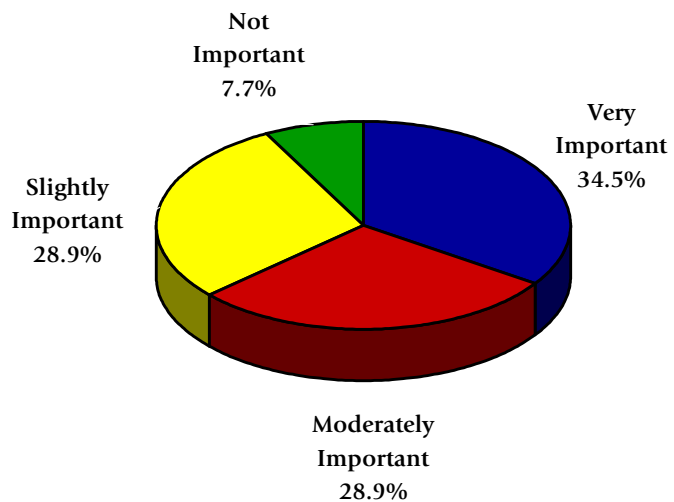
**Quality/Cost of Labor
as an Obstacle to Growth for Your Company**

Quality and Cost of Labor did not register as a significant issue in this survey except, inexplicably, for companies in the \$51-\$100 million annual sales range (60% of respondents in this sub-group cited this as a very important obstacle to growth).



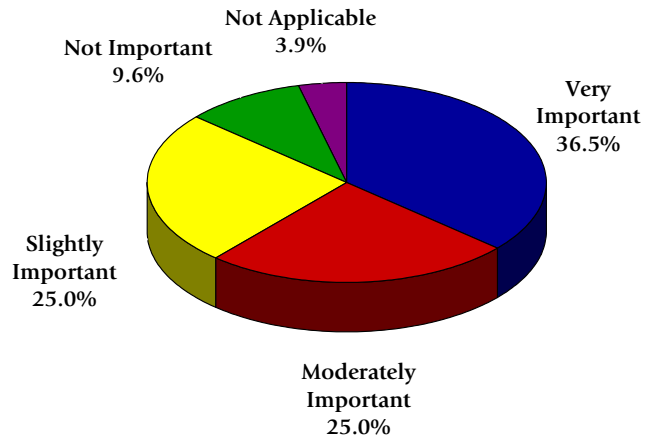
**Energy/Utility Costs
as an Obstacle to Growth for Your Company**

Not surprisingly, energy costs are a moderately to very important obstacle to growth for 64% of respondents. Asked to list their *three biggest obstacles* to profitability, 13 out of 50 responding food industry executives cited energy costs. Energy costs were most acutely perceived to be an obstacle to growth by Category 2 (Further-Processed Ingredients) and Category 5 (Commodity Ingredients) companies, with 55% and 60%, respectively, citing energy and utility costs as very important obstacles to growth.



**Raw Material Sources
as an Obstacle to Growth for Your Company**

Energy and utility costs generally translate into increased raw materials costs, which impact availability. Almost 62% of respondents perceive raw material sources to represent moderately to very important obstacles to growth. This concern rose to 81% for Category 2 companies (Further-Processed Ingredients). Asked to list their *three biggest obstacles* to profitability, 24% of responding food ingredient executives cited rising raw material costs.

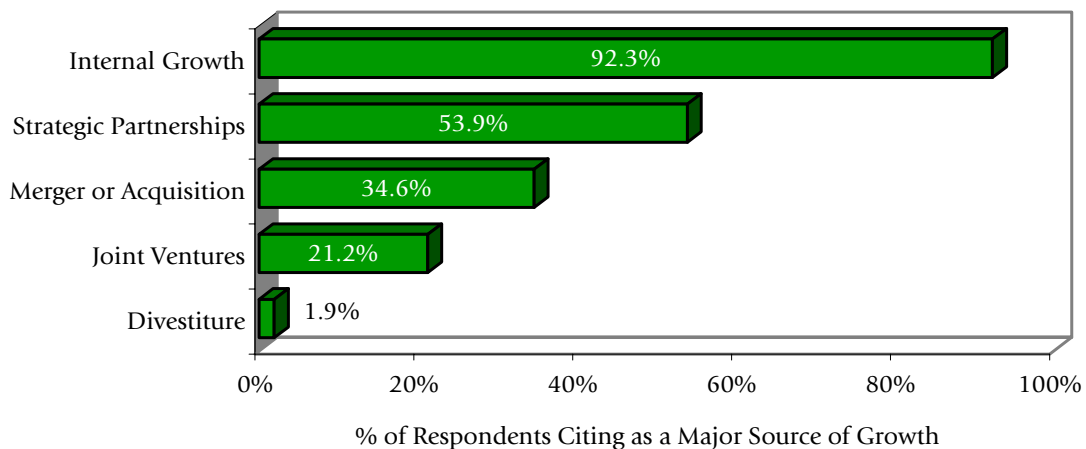


Growth Strategies

How do food ingredient companies plan to grow over the next two years? Growth demands resources, which demand capital. Growth can occur through the development of internal capabilities, but such development can be slowed by internal constraints and limited access to capital. Growth can be accelerated through the more efficient coordination of third-party resources, such as in joint ventures or with strategic partnerships. Or, companies with access to capital and financial guidance can simply accelerate growth through acquisition.

Almost all ingredient suppliers (92%) cite internal growth as their main source of growth. Strategic partnerships (53%) and mergers and acquisitions (35%) are also considered important. Joint ventures were cited by just 21% of respondents to be an important part of their growth strategy

**Sources of Growth
Over the Next Two Years**



Strategic Partnerships

Of the 50 survey respondents, 22 (42%) indicated that their companies had participated in strategic partnerships, with an average success rate of 77%. Thirteen of 50 respondents claimed a 100% success rate.

Company Involvement: Strategic Partnerships			
% of companies in one or more		42%	
		Number of SPs	Success Rate
Average		2	77%
Median		1	100%
Range	Minimum	1	0%
	Maximum	10	100%

Respondents considered the benefits of strategic partnerships to include:

1. Improved product offerings
2. Exposure and access to new markets and product opportunities
3. The building of confidence in and trust with their key customers
4. Working with customers without needing to worry about intellectual property concerns
5. Enjoyment of long-term contracts and improved profitability

Obstacles to strategic partnerships identified by respondents included the need to:

1. Set aside egos
2. Ensure the commitment by each strategic partner to the success of the partnership
3. Deal with "flaky partners"

Mergers & Acquisitions

Mergers and acquisitions offer their own mix of benefits and challenges.

Of the 50 survey respondents, 24 (48%) indicated that their companies had participated in mergers and acquisitions, with an average success rate of 62%. Two respondents indicated that their companies had participated in 20 and 30 mergers and acquisitions, respectively.

Company Involvement: Mergers & Acquisitions			
% of companies in one or more		48%	
		Number of M&As	Success Rate
Average		5	62%
Median		2	78%
Range	Minimum	1	0%
	Maximum	30	100%

There are good ways to pursue acquisitions...and there are bad acquisitions. Three respondents indicated they had zero success with two acquisitions per company, while eight respondents indicated 100% success rates for as many as three acquisitions per company.

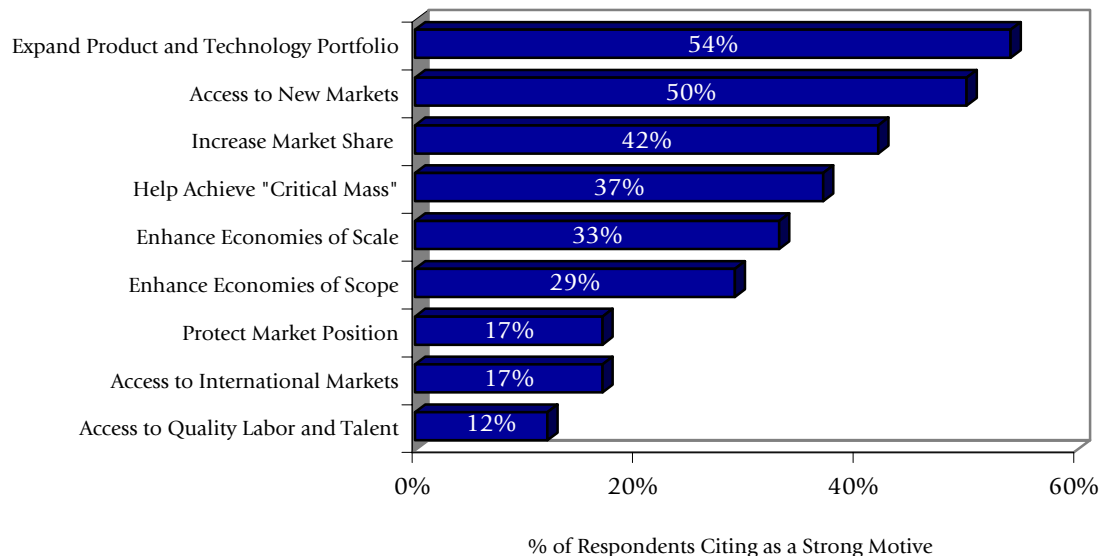
Respondents listed many benefits from mergers and acquisitions, including the following:

1. Market consolidation and achievement of "critical mass"
2. Accelerated participation in industry growth segments
3. Sales expansion and new distribution channels
4. Development of new market synergies using existing capabilities
5. Access to new brands and technologies
6. Exchange of manufacturing technologies
7. Access to key raw materials
8. Improved profitability

However, mergers and acquisitions also pose their own unique set of challenges:

1. High levels of investment required following an acquisition
2. Required access to capital
3. Integration of business cultures, people and technologies (especially for cross-cultural acquisitions)
4. Reallocation of assets to best advantage
5. Maintaining business focus while absorbing acquired company
6. Unrealistic expectations on the part of acquiring companies
7. Disagreements with regard to acquisition target valuations

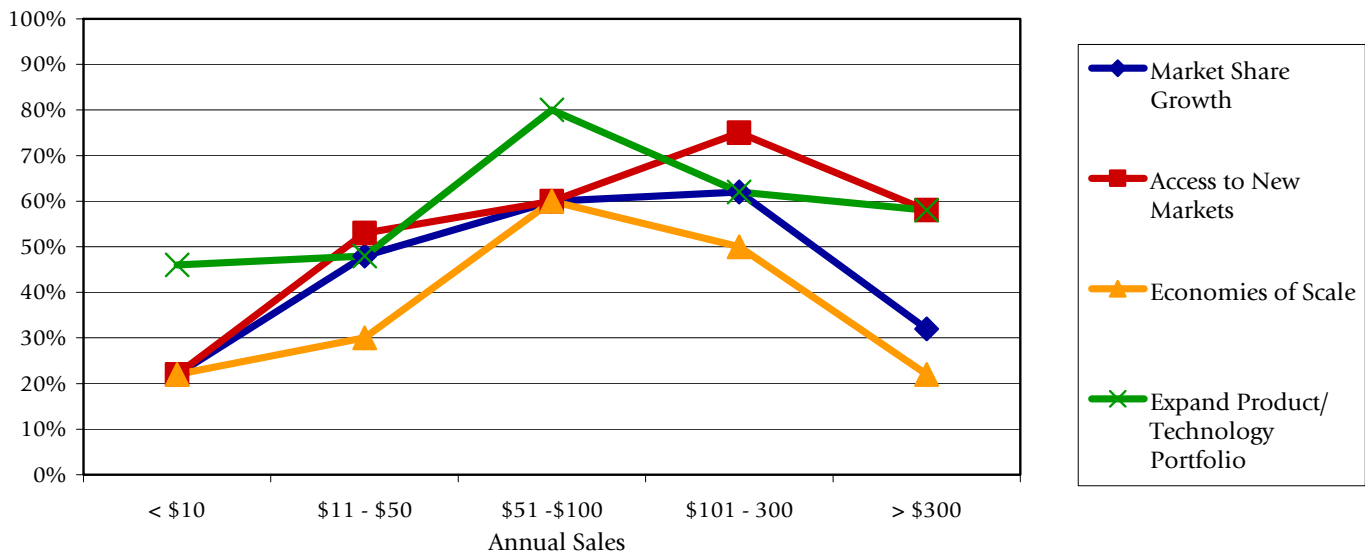
Motives for Mergers and Acquisitions



The leading motives identified for pursuing a merger or acquisition are to gain access to new products, technologies or manufacturing capabilities, followed by access to new markets and market share growth.

Motivations for pursuing mergers or acquisitions change with the size of the acquiring company. Middle market companies were most strongly motivated to pursue acquisitions. Although there was little change in the relative importance of motives, the percentage of respondents indicating strong motives (as distinct from moderate motives) for any particular incentive for pursuing an acquisition exhibited bell-shaped curves, with peaks in the range of \$51 to \$300 million in annual sales.

Motives for Pursuing Merger or Acquisitions as a Function of Company Size



Although differences in acquisition interests are not as evident among product categories, Category 4 companies (Value-Added Commodities) exhibit a stronger inclination to cite access to international markets and achieving “critical mass” as motivators for pursuing acquisitions. They are less likely to cite expansion of their product and technology portfolios as a motivator for acquisition.

Category 5 companies (Commodities) are more likely to cite defensive reasons, such as access to quality labor and talent and protection of their market position as motives for pursuing mergers or acquisitions.

Joint Ventures

Joint ventures represent the fourth-most preferred avenue to growth, with 19 of 50 respondents (38%) indicating that their companies had participated in one or more joint ventures.

Joint ventures take practice and some companies practice more than others. Most responding companies cited their engagement in one to three joint ventures, while two companies cited 10.

Company Involvement: Joint Ventures			
% of companies in one or more			38%
		Number of JVs	Success Rate
Average		3	52%
Median		2	59%
Range	Minimum	1	0%
	Maximum	10	100%

Success rates for joint ventures averaged 52%, although eight respondents cited success rates of 80% or more, including the two companies that listed 10 joint ventures on their resumes.

For respondents happy with joint ventures, benefits cited include the following:

1. Expansion of ingredient applications
2. Acceleration of business
3. Securing of sources of supply
4. Boosting of marketing strength and presence
5. Leveraging of compatible technologies and technology advancement
6. Expansion of sales
7. Achievement of "critical mass"
8. Consolidation of markets
9. Access to capital
10. Enhancement of profitability

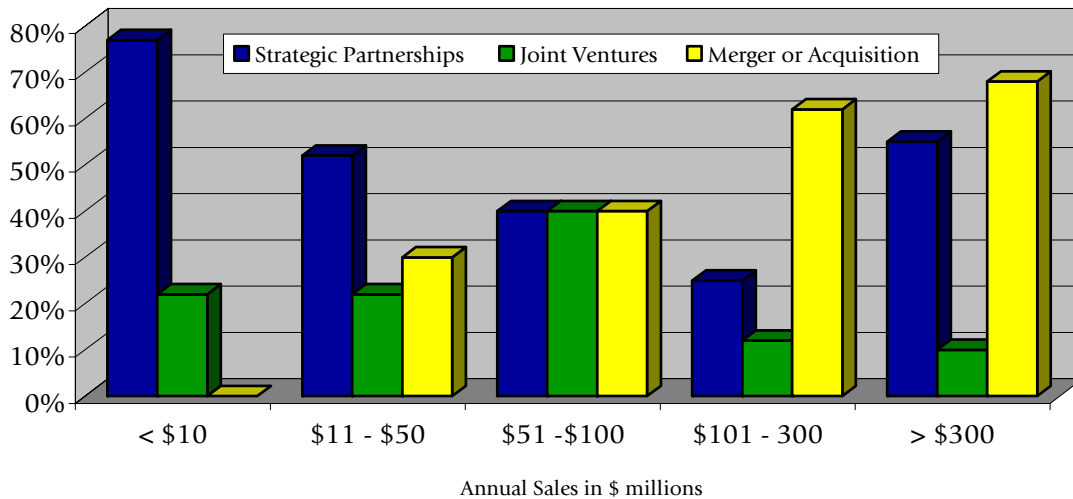
Challenges with joint-ventures tend to reflect a blend of the same challenges associated with mergers/acquisitions and with strategic partnerships, with a hint of impermanence:

1. Cultural and communications issues
2. Lack of time commitments to the joint venture by either party
3. Unrealized synergies
4. Local political issues (within the company)
5. Changes in strategic direction by either partner
6. Companies circumventing their partners in customer relationships

Which Strategy to Use?

Companies' preferred strategies depend, in part, upon company size. Interest in acquisition activity increases as companies grow and (presumably) increase the sophistication of their knowledge with respect to available financial tools and legal guidance while bolstering their balance sheets and depth of management.

Company Growth Strategies
Two-Year Growth Strategies as a Function of Company Size



Suppliers and Processors

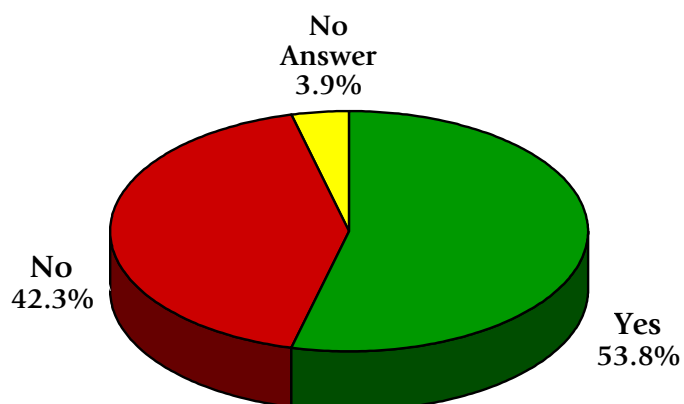
Food Ingredient Suppliers and the Food Industry

Food Regulation

Food ingredient suppliers' perceptions of opportunities for innovation and their relationships between food ingredient companies and the food industry at large were explored on a number of fronts.

FDA Regulatory Policies

Following the recent FDA labeling initiatives pertaining to trans-fatty acids, allergens, and whole grains (to cite a few examples), more ingredient supply companies viewed the FDA regulatory initiatives in a positive light, possibly because FDA regulations can create opportunities for companies to further differentiate their products and services (e.g., trans-fat free ingredient alternatives).



Are the FDA's regulatory policies improving R&D opportunities for the food industry?

Some companies disagreed eloquently with this premise, however. Reasons cited for disagreement include:

1. FDA actions pushed companies to focus more on quality issues rather than on innovation
2. Regulatory compliance costs are onerous and detract from innovation
3. FDA actions have been ineffective in eliminating consumer confusion over conflicting nutritional studies
4. The FDA is too slow to react to new products and innovations
5. FDA regulations impede business transactions
6. The FDA exhibits poor clarity in its rule making, such as for saturated fat labeling
7. The FDA lacks resources to back up its regulations with enforcement (presumably penalizing those companies that comply – *Ed.*)

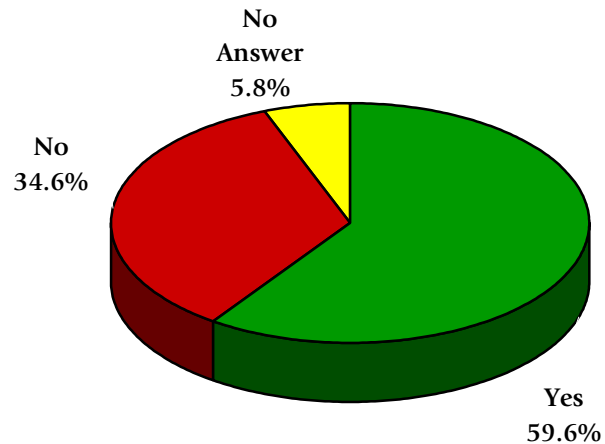
These responses should provide good benchmarks for food ingredient supplier perceptions of future FDA initiatives.

The U.S. Manufacturing Environment

Against a backdrop of a globalizing food economy rife with fears of outsourcing and other perceived threats to the status quo, food ingredient executives were asked about the state of the U.S. manufacturing environment. Overall, the U.S. manufacturing environment received positive marks from 60% of respondents.

The U.S. Manufacturing Environment

Attitudes toward the manufacturing environment were most positive among Category 4 respondents (Value-Added Commodities), at 86%, and middle market-sized companies with \$51-100 million in sales, at 80%. Perceptions of the manufacturing environment in the U.S. were least positive among the smallest companies (those posting less than \$10 million in annual sales), with only 46% of respondents agreeing with this premise. Asked which countries or regions provided a better manufacturing environment, respondents cited Latin America, Eastern Europe and even Africa. China received only one mention.



Does the U.S. provide the most favorable manufacturing environment for the U.S. food industry?

Innovation Drivers

Food ingredient company executives were asked an open-ended question regarding "what is the *single most important factor* driving innovation in the (food) industry?"

In addition to the usual suspects (e.g., consumers, customer demands, nutrition, profits, etc.), some of the more insightful comments included:

1. Small, nimble companies able to bring new insights to nimble players
2. Margin management
3. Translating health and nutrition into good-tasting products
4. Linking R&D costs to reasonable market outcomes
5. Replacement of ingredients with "bad" connotations with "good for you" ingredients
6. Changing demographics (growing Hispanic populations, aging Baby Boomer populations)

Future Challenges

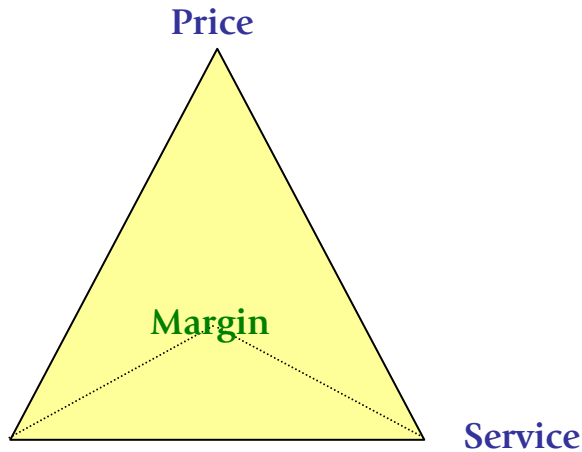
Food ingredient company executives were asked "What is the greatest concern that you have concerning the future of the U.S. food industry?" Responses, in the order of frequency were:

1. Industry consolidation and loss of identity
2. "Magic Bullet Syndrome" – defined as the drive to apply simplistic solutions to perceived problems, resulting in increasing complexity in the industry
3. Excessive and overlapping regulations from too many agencies
4. Margin compression, resulting from the inability of food manufacturers and suppliers to absorb increasing costs
5. A national disaster, such as bioterrorism
6. Store brands controlling consumer choices
7. Purity, safety and wholesomeness
8. The transfer of food industry manufacturing overseas
9. Over-dominance by Chinese food processors and ingredient suppliers
10. The industry's inability to "think outside the box"
11. The cost of regulatory compliance, as compared to those incurred by international suppliers
12. Over-burdensome quality regulations as a barrier to innovation
13. Energy, labor and transportation costs
14. Class action suits over issues such as obesity

Asked about other concerns, most mentioned rising energy and manufacturing costs and the negative impact of increased government regulation and quality standards on innovation.

Customer Satisfaction and The Value Proposition

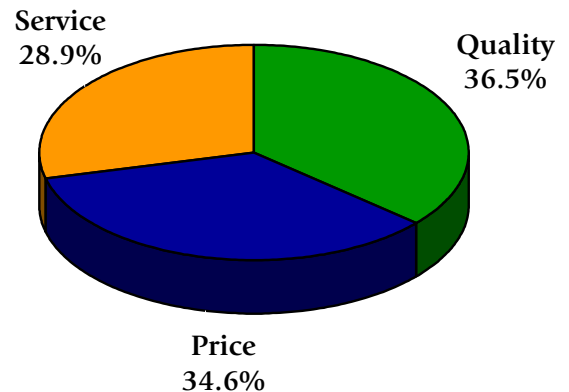
Good intentions notwithstanding, food ingredient suppliers can't be all things to all customers. Choices must be made. The value proposition for products can be defined as a balance between product price, product quality and service. Suppliers cannot yield on one variable without affecting another.



Balancing Price, Quality and Service

Food ingredient company executives were asked how they balance price, quality and service in response to their customers' needs, and which of the three they believe is most important to their customers.

Quality was ranked most important by a small margin. This held true for every product category except Category 1 (Specialty Ingredients) and Category 3 (Food Additives and Specialty Chemicals), where price trumped both quality and service as the most important customer criterion.

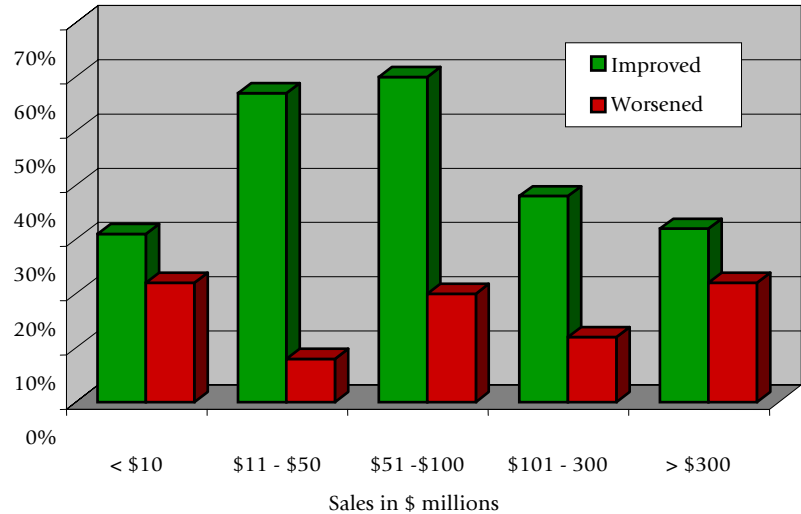


Which is most important to your customers?

Given the current management emphasis on win-win relationships, how have relations between suppliers and their customers changed?

Supplier/Manufacturer Working Relationships

The survey asked food ingredient industry executives if the ability of food industry executives to work with food manufacturers has improved, stayed the same or worsened. The news, overall, is positive. 40% of all respondents reported that relations had improved, versus 15% that indicated relations had worsened. This trend held across all company sizes and ingredient categories, with one exception: 32% of companies in Category 1 (Specialty Ingredients) indicated that relations had worsened, versus 27% that viewed relations as improved.



During the past two years, has the ability of food ingredient suppliers to work with food manufacturers improved or worsened?

Responses as a function of company size

Food ingredient executives cited the following reasons for improved working relationships with their customers:

1. The downsizing of R&D by food manufacturers
2. Lack of R&D skills among food manufacturers, causing greater reliance on suppliers for technical assistance
3. A greater willingness by food manufacturers to share R&D costs with their suppliers
4. Fewer food ingredient companies being capable of providing "personal service"
5. Increased cooperation between suppliers and manufacturers to accelerate innovation
6. Increased needs by manufacturers to reformulate existing products in response to consumer trends and regulatory changes
7. The development of R&D facilities and personnel by ingredient suppliers in support of customer needs
8. Improved services and communications capabilities
9. Increased consumer demands for specialized nutritional benefits

Among those food industry executives lamenting worsened relations between food ingredient suppliers and their customers, reasons cited included:

1. The perception that food product development answers too much to marketing, rather than innovating on its own in search of new health alternatives
2. An overemphasis on cost reductions and pricing rebates rather than innovation by food manufacturers
3. Customer ignorance regarding the values to be gained from consolidation of purchasing power
4. The lack of decision makers as an outcome of downsizing and consolidation among food manufacturers
5. An overemphasis on price versus service and quality
6. Organizational chaos within large food manufacturers

J.H. CHAPMAN GROUP, L.L.C.

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The firm was founded in 1982 to serve one under-represented niche—the food industry—and subsequently expanded to include apparel and other consumer products, retailing and services.

Our firm is comprised of eight experienced principals - all with impressive business credentials, particularly in the food industry. We specialize in transactions between \$10 million and \$500 million, working with clients ranging from established, closely held businesses to Fortune 500 companies. Headquartered in Chicago with our European office in Paris, and our affiliates in Buenos Aires, we have established an enviable track record of success and an extensive network of contacts around the globe.

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